India

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The Evolution of Transfer Pricing Jurisprudence in India

This article analyses the legal jurisprudence landscape with regard to transfer pricing that is slowly emerging, and sheds some light on the various transfer pricing controversies in India. Debatable transfer pricing audit issues are considered as well.

1. Introduction

Transfer pricing in India has evolved significantly. In the 10 years since implementation of the transfer pricing regulations and in the course of five rounds of completed audits (assessments), transfer pricing has gained pivotal importance not only for the business community but, more importantly, for the tax authorities. Transfer pricing assessments in India have generated great controversies due to an exponential increase in audit activity and resulting transfer pricing adjustments.

The transfer pricing landscape continues to evolve in India. So far audits have been characterized by numerous meetings with transfer pricing officers and an exchange of voluminous documentation and information relating to the taxpayer's transactions and business. The buoyant Indian economy and impressive financial performance of Indian companies have strengthened the outlook of transfer pricing officers that multinational enterprises operating in India should have robust transfer pricing between group companies, resulting in healthy margins for Indian operations. The recent proposal in the law to increase the statutory timeframe permitted for transfer pricing audits by 10 months is a clear indication of the enhanced focus of the Indian tax authorities on transfer pricing audits.

This article will analyse the legal jurisprudence landscape that is slowly emerging, and will in turn shed some light on the various transfer pricing controversies in India. Thus, debatable transfer pricing audit issues are considered initially so as to facilitate an appreciation of the legal jurisprudence evolving on this subject.

The following are some of the important audit issues which have arisen.

1.1. Information technology

The tax authorities, without appreciating the limited-risk nature, and functional or value chain analysis of captive Indian business-process outsourcing and offshore software development entities, have considered comparables operating with significantly different business models as well as comparables bearing full entrepreneurial risks. Accordingly, transfer pricing officers have expected limited-risk captive service providers to earn margins comparable to full-fledged entrepreneurs.

Similarly, captive research and development companies and investment advisory companies have faced transfer pricing adjustment issues.

1.2. Management fees

Extensive documentation is sought to justify the costs allocated by group entities regarding benefits derived by Indian entities from centralized service departments of multinational enterprises. For example, the composition of costs allocated, the methodology for allocating costs and benefits derived from each constituent of the costs have been sought to justify the arm's length nature of the charges.

1.3. Intangibles

The role of intangibles in transfer pricing matters has become perhaps the most controversial issue internationally. In India, the payment of royalties for the use of intellectual property such as trademarks, know-how and brand names is a matter of focus for the tax authorities.

The payment of royalties for the use of intellectual property within the limits prescribed by the Reserve Bank of India (the central bank of India) is not accepted in all cases by the tax authorities as respecting the arm's length standard. The tax authorities also seek evidence of whether other group entities outside India are paying the same royalty rate to license the same intangibles, whether the know-how was received by the Indian entity and the benefit derived from the intellectual property by the Indian licensee. In many cases, the tax authorities have rejected the taxpayer's analysis and disallowed payments for the use of intellectual property relating to technical know-how, on the grounds that the taxpayer has failed to commensurately show:

- the need to source the intellectual property from abroad;
- appropriate documentation evaluating and describing the intellectual property;
- that the Indian entity has fulfilled the benefits test; and
- that the royalty is not embedded in the import price of goods.

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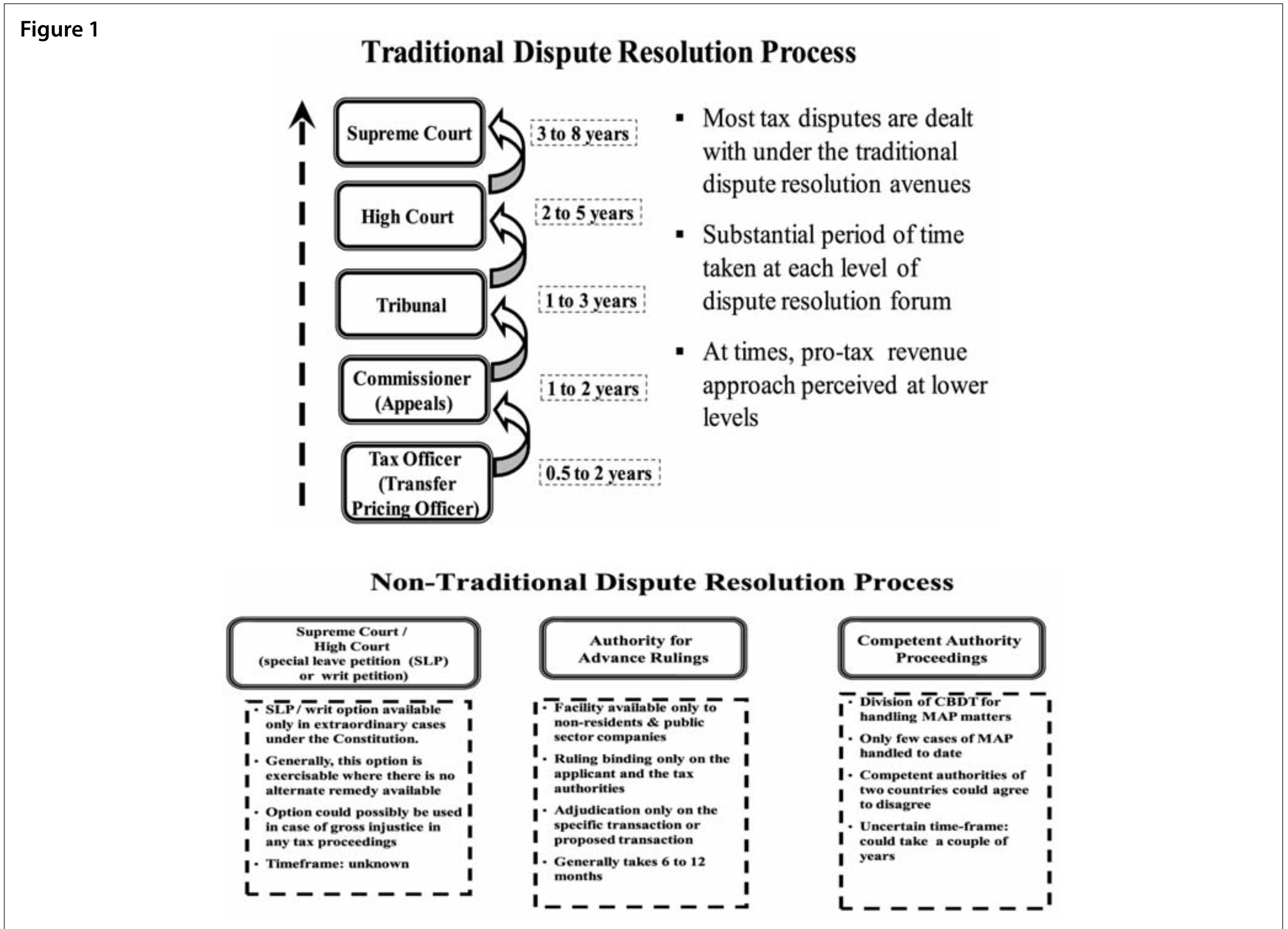
Figure 1



1.4. Other issues

In addition to the above issues, transfer pricing adjustments have also revolved around the use of past or multiple-year data of comparables and the use of updated data subsequently available during audit proceedings. Issues include transactional, product wise and segmental analysis of the taxpayer's operations as compared to an aggregated or basket-of-products approach; the use of comparables not available in the public domain; and the acceptability of loss-making comparables or the taxpayer's loss situation. Many taxpayers feel that the tax authorities are unable to appreciate business dynamics, taxpayers' market strategies and commercial considerations.

2. Indian Dispute Resolution Process

2.1. Generally

An understanding of the Indian dispute resolution process is essential to analyse the ramification of the Indian jurisprudence on this matter. The traditional as well as non-traditional dispute resolution processes are as in Figure 1.

With a view to expedite the process of resolution of tax disputes and to improve the foreign investment climate in India, Finance Act (No. 2), 2009 added a new dimension to the dispute resolution process with effect from 1 October 2009. Finance Act (No. 2), 2009 provided for an alternate dispute resolution mechanism by means of the establishment of a Dispute Resolution Panel, which would operate as a collegiums comprising three commissioners of income tax as constituted by the Central Board of Direct Taxes (CBDT), an Apex body which administers direct tax matters.

The Dispute Resolution Panel mechanism is available to Indian companies that face transfer pricing adjustments, and also to foreign companies regardless of whether they are faced with a transfer pricing adjustment (eligible taxpayer). The taxpayer has an option to file either an appeal against the order issued by the tax authorities with the first Appellate Authority (Commissioner (Appeals)) or objections against the order issued by the tax authorities with the Dispute Resolution Panel.

The main advantage, which favours the Dispute Resolution Panel route vis-à-vis the traditional dispute resolution process, is that the tax demand is kept in abeyance until the finalization of the assessment order (i.e. an additional nine months). This comes as a relief for taxpayers that were generally required to pay a significant portion of the tax demand even while appeals were pending with the Commissioner (Appeals) under the traditional dispute resolution process, unless a stay of demand was granted by the tax authorities; if not, a writ petition to the High Court was the only recourse. Another advantage of the Dispute Resolution Panel route is that it will certainly be a quicker avenue to the

Second Appellate Authority, i.e. the Tribunal, in the event that the Dispute Resolution Panel is to decide against the taxpayer. Even if the Dispute Resolution Panel should decide in favour of the taxpayer, the tax authorities lose their right to appeal against the directions of Dispute Resolution Panel, which clearly helps taxpayers in attaining early finality with regard to issues on transfer pricing.

An analysis is provided below with regard to the key transfer pricing judgements rendered to date.

2.2. *Philips Software Centre Private Ltd. v. ACIT*[1]

2.2.1. *Facts of the case*

Philips Software Centre Private Ltd. (the taxpayer), a risk-insulated captive software development services company, rendered services to its overseas associated enterprises. To substantiate the arm's length nature of its international transactions for assessment year 2003-04 (relevant to financial year 2002-03), the taxpayer conducted a transfer pricing study, wherein:
- the cost-plus method was considered as the most appropriate method, and the transactional net margin method (TNMM) was considered as a supplementary method;
- a search for comparable companies was conducted on the Capitaline database using various filters (system based and manual);
- the data of comparable companies for financial year 2002-03 that existed immediately prior to the specified date (i.e. tax return due date for assessment year 2003-04) was used as required under Rule 10D(4) of the Income Tax Rules (ITR); and
- the search resulted in a set of nine comparable companies that survived the elimination process; an adjustment for differences in depreciation policy was made to the comparable companies to arrive at the arm's length price.

The transfer pricing officer issued a show-cause notice indicating that he did not agree with the taxpayer's depreciation adjustment. He conducted a fresh search on a different database and selected the TNMM over the cost-plus method that had been used by the taxpayer.

The taxpayer made detailed submissions against the show-cause notice. Finally, the transfer pricing officer issued his order computing the arm's length price by using the mean margin of seven comparables at 21.14% (as against the mean margin of 16.82% in the show-cause notice).

On appeal, the first appellate authority, the Commissioner (Appeals), granted marginal relief to the taxpayer by reducing the arm's length profit margin to 20.47% (from 21.14%). However, the taxpayer sought an appeal before the second appellate authority (the Tribunal).

2.2.2. *Ruling of the Tribunal*

The Tribunal's key observations and conclusions are summarized below.

2.2.2.1. Comparability analysis

The data to be used in a comparability analysis must be contemporaneous. The requirement of the law is two-fold:
- such data must relate to the financial year in which the international transaction was entered into (Rule 10B (4) of the ITR, where the proviso is not attracted); and
- such data must exist as by the specified date (Rule 10D (4) of the ITR).

The conditions mentioned in Rule 10B (4) and Rule 10D (4) of the ITR are cumulative in nature, and if any one of them is not satisfied, the relevant comparable ought not to be included in the comparability analysis. Both the rules co-exist and should be read harmoniously; otherwise the taxpayer would be required to maintain two separate sets of documentation.

The taxpayer conducted its analysis by using a database in October 2003, which was reasonably close to the specified date of 30 November 2003, whereas the transfer pricing officer conducted a fresh comparability analysis beyond the specified date by using data which were not "contemporaneous", and hence, his analysis was not in compliance with Rule 10D (4) of the ITR.

2.2.2.2. Search process

The taxpayer followed a methodical search process starting with a set of companies that were potentially comparable, and eliminating non-comparable companies through a filtration process. This process resulted in a final set of comparables that had survived elimination. On the other hand, the transfer pricing officer resorted to cherry-picking comparables.

The transfer pricing officer did not (1) question the database used by the taxpayer, (2) question the data which emanated from such databases, (3) specifically reject the database used by the taxpayer or (4) provide any reason for using the new database. As there were no shortcomings in the method adopted by the taxpayer, the transfer pricing officer was not justified in considering another method as the most appropriate method.

Even where a shortcoming has been identified, the action of the transfer pricing officer would be restricted to taking remedial action commensurate with the identified shortcoming, and not beyond.

2.2.2.3. Related-party transaction in comparables

Rule 10A (a) of the ITR clearly provides that for the purpose of comparability analysis, the comparable companies may not have transactions with their associated enterprises. In other words, a company having related-party transactions cannot be considered as a comparable company. This view was supported by the

1. 26 SOT 226 (Bangalore Tribunal).

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Tribunal in *Mentor Graphics (Noida) (P.) Ltd. v. DCIT*[2] and draft notes on comparability issued by the OECD.

2.2.2.4. Adjustments to the margins of the comparables

The following points must be considered before concluding that the taxpayer operates in a risk-insulated environment: (1) the taxpayer operates on a cost-plus model and is compensated for all the costs borne by it, (2) the quantum of business of the taxpayer has consistently grown over the years and (3) the levels of risk borne by third-party comparables are much more than those of the taxpayer.

The list of those captive companies which have earned a high level of profit (as forwarded by the transfer pricing officer) cannot be used to arrive at a conclusion for allowing a risk adjustment. This is because that list is flawed due to (1) the fact that some companies on the list are not captive service providers, (2) the data represent secret comparables data and may not be considered and (3) the companies have related-party transactions.

Further, there are other captive companies that have earned margins in the region of 5% to 10% which the authorized representative of the tax department did not consider. This clearly shows that the authorized representative of the tax department is highlighting only companies at the higher end of the spectrum by resorting to cherry-picking comparables without doing a proper analysis of functions, assets and risks borne.

An adjustment on account of a difference in risk profiles may be derived by subtracting the risk-free bank rate from the prime lending rate. During the previous year relevant to assessment year 2003-04, such difference worked out to 5.25%. Even though the risk adjustment may be much more than that, in order to limit controversy the risk premium of 5.25% must be considered as a risk adjustment.

Considering Rule 10B (1)(e)(iii) of the ITR, an adjustment for a working capital difference is required for an equitable comparison. In the instant case, the taxpayer had prepared a computation of the working capital adjustment on the prime lending rate at 5.93%, and the Tribunal noted that the computation was in line with the draft guidance on comparability issued by the OECD.

2.2.2.5. Normalization of the profits of super-profit-making comparable companies

The transfer pricing officer/Commissioner (Appeals)'s act of "normalizing" the super profits of two comparable companies selected by the transfer pricing officer (by substituting profit margins of the next highest profit-making companies from the set of final comparables) was incorrect, as there were no statutory provisions regarding normalization. Such companies should have been excluded from the list of comparables.

2.2.3. Rationale of the ruling

This is a significant ruling in the area of Indian transfer pricing. The Tribunal dealt with the core transfer pricing issues relating to the use of contemporaneous data by the specified date, rejection of related-party transactions, quantification of risk and working capital adjustments. The main premise of this order is that the discretion granted under the Income Tax Act to the tax authorities in the field of transfer pricing is not unfettered. It must be utilized for the purposes for which it was granted, it must be used within the framework of the law and, above all else, it must be reasonably exercised. In general, the transfer pricing analysis prepared by the taxpayer stands unless the transfer pricing officer rejects it as being completely flawed. In the absence of such a rejection, the transfer pricing officer cannot deviate from the analysis except on specific issues where the taxpayer is shown to be wrong.

Although a stay has been granted by the High Court in this case, the important transfer pricing principles brought out in the ruling are noteworthy.

2.3. *DCIT v. Quark Systems Pvt. Ltd.*[3]

2.3.1. Facts of the case

Quark Systems Pvt. Ltd. (the taxpayer), an Indian company, was a wholly owned subsidiary of a Switzerland-based company, Quark Systems SARL, Switzerland (Quark-Switzerland). The taxpayer was a captive unit working exclusively for Quark-Switzerland. The taxpayer entered into a contract on 1 April 2001 with Quark-Switzerland to provide technical and advisory services. Quark-Switzerland made specialized software for media companies which was used for page layout of newspapers and periodicals. Pursuant to the contract with its parent company, the taxpayer assisted Quark-Switzerland by way of providing technical assistance to customers facing problems and was a dedicated service provider for this purpose. Based on the agreement, the taxpayer received remuneration of 10% on costs, increased to 13.5% with effect from September 2001.

The taxpayer had used the TNMM to benchmark its international transactions. The transfer pricing officer noticed that the taxpayer had included Imercius Technologies India Pvt. Ltd. (Imercius) as an independent comparable company in the computation of the arm's length price, which company showed a net loss at 73.48% and was in the start-up phase of its business operations. The transfer pricing officer issued a show-cause notice as to why Imercius should not be excluded, on the grounds that it is a continuous loss-making company and that it is not functionally comparable with the tested party, i.e. the taxpayer. The transfer pricing officer excluded Imercius and made an upward adjustment to the arm's length price.

2. 109 ITD 101 (Delhi Tribunal).
3. 2010-TIOL-31-ITAT-CHD-SB (Special Bench Of Chandigarh Tribunal).

The Commissioner (Appeals) upheld the exclusion of Imercius, but partly granted relief in favour of the taxpayer by holding that a benefit of 5%[4] should have been given by the transfer pricing officer under Sec. 92(C)(2) of the Income Tax Act (ITA).

Both the taxpayer and the tax department filed an appeal before the Tribunal against the order issued by the Commissioner (Appeals).

2.3.2. Ruling of the Tribunal

The taxpayer raised an additional argument before the Tribunal as to demand the exclusion of an independent company, namely Datamatics Technologies Ltd., which was wrongly included by the taxpayer in computing the arm's length price in its documentation. The tax department rejected this argument, stating that the taxpayer had itself included that company as a comparable company; the taxpayer is estopped from pointing out a mistake in the assessment if such mistake is the result of evidence presented by the taxpayer. After hearing the arguments of both sides, the Tribunal ruled as follows:

- The very basic requirements of the function, assets and risk analysis were not met by the taxpayer so as to justify the inclusion of Imercius as a comparable company. The functions performed by the taxpayer are in the nature of sales and support services for its parent company, whereas the functions performed by Imercius are in the nature of telemarketing services.
- Sales support and technical services are inherently different in character and scope than telemarketing services. In telemarketing, fluctuation of profits is very high as the gains are contingent upon the results obtained. The earnings of a telemarketing company are usually a percentage of the sales generated. By comparison, in sales support and technical services, the gains are not dependent on the business results generated by the services rendered, inasmuch as the profits of the taxpayer are dependent on the services actually rendered by the taxpayer and are not contingent upon the business results generated by such services. A plain functional analysis of services rendered by the Imercius would show that they are not comparable with those rendered by the taxpayer.
- Further, it would be futile to suggest that merely because both the taxpayer and Imercius are grouped under the same head in the Prowess database, comparability is established. The risk analysis of the two organizations clearly shows that these two entities are not on even ground. The business risk in the telemarketing activity is much higher, and Imercius also had a negative net worth. A business organization with negative net worth cannot be treated as being on par with a normal business organization.
- The application of the turnover filter in the Prowess database also leaves much to be desired, and has no rational basis. It is improper to proceed on the basis that a turnover of more than USD 200,000 to infinity is a reasonable classification as a turnover base.
- However, a company cannot be excluded from the list of comparables for the purposes of computing the arm's length price merely because that comparable is suffering losses. Imercius represents an instance where not only the functional area is different, but it also has a negative net worth and the turnovers are not comparable. Thus, order of the Commissioner (Appeals) excluding the start-up company is upheld.
- As regards the admission of additional arguments asserted by the taxpayer for the exclusion of Datamatics Technologies Ltd. with extraordinary profits, the tax department is not justified in arguing that merely because the taxpayer itself has selected that comparable, it is estopped from pointing out a mistake in the assessment even where such mistake is the result of evidence presented by the taxpayer.
- When substantial justice and technical considerations are pitted against each other, the cause of substantial justice ought to be preferred. The tax department cannot claim to have a vested right in injustice being done due to some mistakes on its part.
- Proceedings before the tax authorities are not adversarial proceedings and the taxpayer should not therefore be placed at a disadvantage because of its inadvertent and bona fide mistakes.

2.3.3. Rationale of the ruling

This decision underscores the importance of the search strategy and the functional analysis of both the tested party and comparable companies in a transfer pricing analysis. Further, the acceptance of a loss-making company after detailed analysis, on the grounds that it is part and parcel of economic activity, is a noteworthy observation of the Tribunal. The ability of the taxpayer to resile from its own position because of a factual mistake will bring relief to taxpayers, as transfer pricing is a fact-driven exercise and sometimes inadvertent mistakes can creep in. This establishes that equity and natural justice are important planks for the equitable administration of tax laws.

2.4. *Starlite v. DCIT*[5]

2.4.1. Facts of the case

Starlite (the taxpayer) was a partnership firm engaged in the business of import, manufacture and export of diamonds and jewellery. During the relevant year, the taxpayer exported polished diamonds.

4. Where more than one price is determined by the most appropriate method, the arm's length price is to be taken as the arithmetic mean of such prices, or, at the option of the taxpayer, a price which may vary from the arithmetical mean by an amount not exceeding 5% of such arithmetical mean. (This was subsequently amended by Finance (No. 2) Act, 2009, which provides that if the variation between the arm's length price and the price of the actual international transaction does not exceed 5% of the actual international transaction, it is to be deemed to be the arm's length price.)

5. 2010-TII-28-ITAT-Mum-TP (Mumbai Tribunal).

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In its transfer pricing study report, the taxpayer contended that none of the methods prescribed was adopted for the purpose of benchmarking the international transaction due to the impossibility of adopting one of the methods prescribed under Sec. 92C of the ITA. In response, the transfer pricing officer asserted that where no method was possible to apply, the taxpayer may justify its international transaction using the TNMM as prescribed under Sec. 92C of the ITA.

Based on the search for comparable companies conducted by the transfer pricing officer, he determined an arm's length margin at 9.57% on sales and made an adjustment.

On appeal, the Commissioner (Appeals) ignored the objection of taxpayer regarding the use of the TNMM as the most appropriate method by the transfer pricing officer for determining the arm's length price of the international transaction. Further, the Commissioner (Appeals) qualitatively rejected two companies from the set of comparable companies selected by the transfer pricing officer, and determined an arm's length profit margin of 5.46% on sales. As the operating profit margin of the taxpayer was within +/- 5% of the arm's length profit margin of the comparable companies, the Commissioner (Appeals) deleted the addition made by the transfer pricing officer.

Aggrieved by the order of the Commissioner (Appeals), both taxpayer and the tax department sought an appeal before the Tribunal.

2.4.2. *Ruling of the Tribunal*

The Tribunal agreed with the findings of the transfer pricing officer and held that under the transfer pricing regulations, it is mandatory for a taxpayer to determine the arm's length price for its various international transactions in accordance with any one of the methods prescribed under the ITA. Claiming that none of the methods can be applied does not absolve the taxpayer of its statutory duty in determining an arm's length price under the law.

Taking into account Sec. 92C of the ITA read with Rule 10B of the ITR, the Tribunal held that the TNMM requires a comparison of the net margin realized by an enterprise from an international transaction and not a comparison of the operating margins of the enterprises.

The Tribunal observed that the transfer pricing officer had not applied the TNMM as contemplated under the ITA, and thus set aside the order of the transfer pricing officer for fresh adjudication with the direction to the transfer pricing officer that adjustments, if any, arising due to the computation of the arm's length price be restricted only to the international transaction and not to the entire turnover of the taxpayer which also included transactions with third parties.

2.4.3. *Rationale of the ruling*

Under the transfer pricing regulations, any income or allowance for any expense arising from an international transaction must be computed having regard to the arm's length price. The arm's length price cannot be determined merely on the basis of the methods prescribed under Sec. 92C (1) read with Rule 10B. The application of the methods hinges on the functional and economic analyses, which are the cornerstones of transfer pricing. Transfer pricing is not an exact science. Therefore, it may not be necessary that methods prescribed under the transfer pricing regulations be the only means for determining the arm's length nature of the controlled transaction. The dynamic nature of business may not always allow the application of the specified methods for benchmarking unique transactions. The authors believe that the arm's length standard, which is the foundation of transfer pricing law in India and around the world, is flexible enough to absorb the vicissitudes of business and is not straitjacketed by only methods specified by law. Thus, this decision should be read with the facts of the case and may not have universal application for all unique transactions.

However, the Tribunal has correctly reiterated the philosophy that when applying the TNMM as the most appropriate method, the evaluation must be restricted to international transactions and not to the entire turnover of the taxpayer.

2.5. *Maruti Suzuki Ltd*[6]

2.5.1. *Facts of the case*

Maruti Suzuki India Limited (the taxpayer) was engaged in the manufacture and sale of automobiles. The taxpayer is also engaged in trading in spares and components of automotive vehicles. The *M* trademark / logo was registered in the name of Maruti. The taxpayer entered into a licence agreement with Suzuki Motor Corporation (Suzuki) with prior approval from the government of India for the manufacture and sale of certain SH Series Suzuki four-wheel motor vehicles on 4 December 1992. Suzuki held more than 50% of the share capital of the taxpayer.

Under the licence agreement, Suzuki was to provide to the taxpayer all technical information (whether patented or not), including know-how, trade secrets and other data (including all drawings, prints, machine and material specifications, engineering data and other information, knowledge and advice) relating to the engineering, design and development, manufacture, quality control, assembly, testing, sale and after-sales service of products and parts by Suzuki. Based on the terms and conditions of the agreement, all the products and parts sold by the taxpayer in India had to bear the trademark of Maruti-Suzuki, and the taxpayer was to use the same trademark on containers, packages and wrappings used for and in

6. WP 6876 of 2008 (Delhi High Court).

connection with the sale of such products and parts. Both the taxpayer and Suzuki agreed to apply for registration of the trademark Maruti-Suzuki jointly in India. Further, under the agreement, no trademark other than Maruti-Suzuki was to be affixed by the taxpayer on all the products, parts, containers, packages or wrappings for the products and parts manufactured and sold by the taxpayer. For consideration and licence with regard to the SH Series, the taxpayer was required to pay JPY 500 million in three instalments. The taxpayer was also required to pay a running royalty of 2.5% of the aggregate FOB price of the deleted portion of CKD components, and a running royalty of 2% of the aggregate sum on the ex-factory price of the Maruti parts shipped by the taxpayer (whether for sale in India or for export) for the royalty calculation period. An additional running royalty of 0.5% of the aggregate of the FOB price of the deleted portion of CKD components was required to be paid for exports of parts by the taxpayer.

Prior to 1993, the taxpayer was applying the *M* logo on the front of the cars it manufactured. From 1993, the taxpayer began to apply the *S* logo (which is the logo of Suzuki on the front of the new models) and continued to use the brand name "Maruti" along with the word "Suzuki" on the rear of the cars it manufactured.

During the assessment proceedings, the transfer pricing officer issued a notice to the taxpayer in respect of the replacement of the front *M* logo with the *S* logo with regard to three of its models namely Maruti 800, Maruti Omni and Maruti Esteem. According to the transfer pricing officer, the change of brand logo from Maruti to Suzuki amounted to a sale of the Maruti brand to Suzuki. The transfer pricing officer observed that a substantial amount of royalties were paid by the taxpayer to Suzuki for no contribution of Suzuki towards brand development and penetration in the Indian market. The transfer pricing officer further noted that Maruti had incurred expenditure amounting to USD 818,400 million for advertising, marketing and distribution activities, which aided in the creation of the Maruti brand logo and due to which Maruti had become the top-selling car in India. Accordingly, computing the value of the Maruti brand at cost-plus 8% at USD 818,400 million, the transfer pricing officer issued a show-cause notice as to why the value of the Maruti brand should not be taken at USD 818,400 million and why the international transaction should not be adjusted on the basis of the deemed sale to Suzuki.

In its reply, the taxpayer stated that there was no transfer of the Maruti brand or logo by it. It was also submitted that Maruti had a registered trademark which could be transferred only by a written instrument of assignment (to be registered with the Registrar of Trademarks) and that no such instrument had been executed by Maruti at any point in time. It was further submitted that the taxpayer continued to use the Maruti trademark/logo in all its advertising, wrappers, letterheads, etc. It was because of the large holding by Suzuki in the taxpayer and stiff competition from foreign multinationals that Suzuki had allowed the use of the Suzuki name and logo. Further, Suzuki had not charged any additional consideration for the use of such logo on the vehicles manufactured by the taxpayer.

2.5.2. Ruling of the High Court

Upon review of the show-cause notice, the High Court observed that there was no allegation in the notice that the Suzuki trademark had piggybacked on the Maruti trademark. There was no assertion in the notice that the taxpayer had paid royalties amounting to USD 397.200 million to Suzuki for the licence to manufacture and use the trademark Suzuki. Further, there is no assertion in the notice that the taxpayer had paid royalties for the use of the co-branded Maruti-Suzuki trademark and that there was a deficiency in the value of the trademark, or that the use of the co-branded trademark resulted in reinforcement of the Suzuki trademark.

Upon review of the agreement, it is clear that the taxpayer did not transfer its brand or logo to Suzuki. No right was given to Suzuki to use either the brand or logo of Maruti. It is only the taxpayer which was given the right to use the brand name or logo on its products. Suzuki, even if it should want to, cannot use the joint trademark Maruti-Suzuki on its products, containers, packaging, wrapping, etc. Further, the Maruti-Suzuki trademark has not been registered with the Registrar of Trademarks.

When the show-cause notice was issued to the taxpayer, it was based solely on the premise that the Maruti trademark had been transferred by the taxpayer to Suzuki, and the transfer pricing officer did not inform the recipient of the notice that he had abandoned the show-cause notice issued by him and was now proceeding on an altogether different ground for the purpose of making adjustments to the taxpayer's income, seeking additional information, without expressly conveying the grounds for the proposed adjustment. Thus it cannot be said to be an appropriate substitute for the show-cause notice, which was otherwise required to be issued to the taxpayer.

The purpose of a show-cause notice is to enable the taxpayer to respond to the grounds on which the arm's length price paid by the taxpayer is sought to be rejected, and an adjustment is proposed to be made to the taxpayer's income by the transfer pricing officer. Thus the grounds must be conveyed to the taxpayer in a clear, cogent, specific and unambiguous manner. If such procedure is not followed by the administrative authorities, the power of the High Court under Arts. 226 and 227 of the Constitution may be invoked to prevent gross injustice.

The onus is on the taxpayer to satisfy the transfer pricing officer that the consideration in its international transactions reflects an arm's length price as computed under Sec. 92 of the ITA.

The use of intangible assets like trademarks, logos, etc. belonging to a foreign company, by an Indian company, does not envisage any payment for such use, whether

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such use is obligatory or discretionary, unless there is an agreement between the companies, envisaging such payment.

In the case of controlled transactions, the discretionary use of intangible assets of the foreign associated enterprise by the Indian company does not cause there to be any payment due to the foreign company. However, the income arising from such transaction must be determined on an arm's length basis.

Compulsory usage of a foreign trademark or logo by an Indian company results in the creation of marketing intangibles for the foreign company, and hence the Indian company must be compensated at arm's length for promoting the foreign brand in India. However, such payment for marketing intangibles is fact specific and hence must be evaluated considering all the economic parameters of the transaction.

The expenditure incurred by an Indian company for an associated enterprise on advertising, promotion and marketing of its products using a foreign trademark or logo does not require any payment or compensation by the owner of such trademark or logo in promotion, advertising and marketing undertaken by it, so long as the expenses incurred by the Indian company do not exceed the expenses which a similarly situated comparable independent Indian company would have incurred.

If the expenditure incurred by an Indian entity for an associated enterprise using a foreign brand trademark and/or logo while advertising, marketing and promoting its products, are more than what a similarly situated and comparable independent Indian company would have incurred, such foreign entity must suitably compensate the Indian entity for the advantage obtained by it in the form of brand building.

2.5.3. Rationale of the ruling

This ruling brings out the importance of the procedure to be followed by an administrative authority in administering the law, equitably and judiciously. The ruling also touches upon the important aspects of the use of intangible assets, specifically trademarks and logos. The ruling has sought to discern between normal and excessive advertising and promotional expenditure. It tends to point to the direction that such excessive expenditure results in the creation of marketing intangibles for the foreign company, by promoting the foreign brand in India. This, however, is a nebulous field, since the determination as to what constitutes brand maintenance and what brand creation expenditure is highly subjective. Thus, one hopes that this decision is interpreted in consonance with the facts of the case and is not read so broadly as to paint the complete canvas of all marketing expenditure, so that it always results in the creation of marketing intangibles, as the definition of "marketing intangibles" is uncertain.

The High Court's view is not absolutely clear with regard to the transactions between the associated enterprises, for the use by the Indian entity of a trademark and logo owned by the foreign entity, when such use of the trademark and logo is at the discretion of the Indian entity. Although the High Court observed that no payment must be made with regard to the same, in the same paragraph the High Court also states that the income arising from such transaction must be determined on an arm's length basis. The authors therefore believe that the use of such intangible assets must be compensated on the arm's length basis, even if such use is at the discretion of the Indian entity.

2.6. *Perot Systems TSI (India) Ltd. v. DCIT*[7]

2.6.1. Facts of the case

Perot Systems TSI (India) Private Limited (the taxpayer) is engaged in the business of designing and developing technology-enabled business transformation solutions and providing business consulting, systems integration services and software solutions and services. The taxpayer extended two foreign currency loans to its associated enterprises, namely HPS Global Systems (Bermuda) Limited (HPS Bermuda) and HPS Global Systems Hungary Liquidity Management LLC (HPS Hungary), worth USD 1.5 million and USD 4.6 million, respectively, in January-February 2001.

During the course of assessment proceedings, the transfer pricing officer concluded that the international transactions undertaken by the taxpayer, in relation to the interest-free loan, were not at arm's length and made an upward adjustment to income. The order issued by the transfer pricing officer was upheld by the Commissioner (Appeals), and the taxpayer subsequently filed an appeal before the Tribunal.

2.6.2. Ruling of the Tribunal

Considering the arguments of both the taxpayer and the revenue service and upon review of the order of the Commissioner (Appeals), the Tribunal observed as follows.

The taxpayer's contention is that no one would have given the associated enterprises a loan at that point in time as they were in the start-up phase and the debt ratio did not provide comfort to lenders. Even if one were to accept this argument, there is no case for not providing or charging any interest if the taxpayer is coming to the rescue of the associated enterprises. The Tribunal observed that it has not come across any feature in the agreement to accept the contention that loan was quasi-capital. It is also not the case that there was any technical problem that prevented the loan from being contributed as capital originally if it were actually meant to be a capital contribution.

If the taxpayer's contention is accepted that no adjustment should be made whenever an interest-free loan is granted to an associated enterprise, it would be tantamount to removing such transactions from the realm of

7. 2010-TIOL-51-ITAT-Del (Delhi Tribunal).

Sec. 92(1) and Sec. 92B of the ITA. Sec. 92(1) mandates that any income arising from an international transaction be computed having regard to the arm's length price. The question of the interest rate on the loan is an integral part of determining an arm's length price.

Further, the Tribunal found no discrepancy in the finding of the Commissioner (Appeals) that the economic substance of the transaction is that of a debt and not in the nature of equity or quasi-equity.

Another argument of the transfer pricing officer was that one of the associated enterprises is situated in a tax haven and the failure to charge interest by the taxpayer from the associated enterprise would result in higher income in the hands of the associated enterprises (and the income of the taxpayer in India would be reduced by a corresponding amount). Thus, this would bring down the overall tax burden of the group by shifting profit from India to Bermuda (a tax haven with a zero rate of tax on corporate profits). This is a classic case of violation of transfer pricing norms where profits are shifted to a tax haven or low-tax regime so as to reduce the aggregate tax liability of a multinational group.

Further, as observed by the transfer pricing officer, even if profits are sufficient, it is not mandatory to declare a dividend, as such profits may be retained in Bermuda for further investment in group companies. There is considerable cogency in this argument.

The Tribunal fully agreed with the findings of the Commissioner (Appeals) that the issues raised by the taxpayer, including reliance on Para. 1.37 of the OECD Guidelines, the reference to the UK Tonnage Tax Manual and the reliance on the Hungarian thin capitalization rule, are misplaced and did not provide any shelter to the taxpayer with regard to its granting of interest-free loans to the associated enterprises.

The approval given by the Reserve Bank of India does not provide a seal of approval on the true character of the transaction from the perspective of transfer pricing regulations, as the substance of the transaction must be judged to determine whether the transaction is arm's length.

The Tribunal agreed with the findings of the Commissioner (Appeals) that first and foremost the reason for not allowing a deduction of 5% from the arm's length interest is the fact that there is not more than one price with regard to each of the transactions, as the specific one-year LIBOR rate has been held to be arm's length consideration for the transactions. Therefore, the Tribunal, in agreement with the Commissioner (Appeals), held that the 5% allowance is itself ineffective.

2.6.3. Rationale of the ruling

This ruling would create a hurdle for all Indian companies trying to become a multinational by setting up subsidiaries outside India. This is especially true with regard to the initial stages of their operations outside India, as their functioning would be hampered by the transfer pricing law, which could be at variance with business needs. This could also affect similar financial transactions.

This ruling indicates the importance of legal agreements, such that if they are not in synch with the economic rationale, the form of the transaction could have repercussions. The authors believe that this and similar financial transactions could be an appropriate circumstance for the Central Board of Direct Taxes to take into consideration when framing safe harbour rules.

The Tribunal also held that the benefit of +/- 5% should be given only where more than one arm's length price is determined.

2.7. *Intervet India Pvt. Ltd. v. ACIT*[8]

2.7.1. Facts of the case

Intervet India Pvt. Ltd. (the taxpayer) was engaged in manufacturing and trading of animal health and veterinary products. The product range of the taxpayer included pharmaceutical products, feed additives, poultry vaccines, canine vaccines, foot and mouth disease vaccine, viral and bacteria. The taxpayer was a wholly owned subsidiary of Intervet Holding B.V. Netherlands. Intervet Group entities were part of the Akzo Nobel Group, a multinational group with headquarters in the Netherlands.

During the year under consideration, the taxpayer undertook transactions with its associated enterprises which included the import of raw materials and finished goods; export of raw materials and finished goods; reimbursement and recovery of expenses; and internal audit services. The taxpayer used the TNMM as the most appropriate method to benchmark the international transactions undertaken with its associated enterprises.

As regards the export transactions with associated enterprises, the transfer pricing officer observed that the taxpayer had exported five products to associated enterprises and unrelated parties. With regard to four products, the price charged by the taxpayer was more or less similar to the price charged by it to the unrelated parties. However, in the case of one product, namely Floxding 10% (50ml) (Floxding), the price charged to associated enterprises was much less in comparison to that charged to unrelated parties. The sale price of Floxding to unrelated parties was USD 3.66 per unit, as compared to a sale price of USD 1.17 per unit that was charged to associated enterprise. The taxpayer was asked why the CUP method should not be applied in the instant case.

In reply, the taxpayer submitted that if the CUP method were to be applied, reasonable adjustments were required in order to arrive at a reasonable price. The taxpayer offered adjustments for the high volume of sales to associated enterprise as compared to unrelated parties,

8. 2010-TII-12-ITAT-Mum-TP (Mumbai Tribunal).

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difference in the credit period, credit risks and adjustments on account of annual and future business with associated enterprise and unrelated parties. For this purpose, the taxpayer claimed an adjustment of 40% to the price on the grounds that even in domestic situations, the percentage of discounts varies directly with the volume of sales in the range of 25% to 40%.

The transfer pricing officer, after considering the arguments submitted by the taxpayer, concluded that the adjustments sought by the taxpayer with regard to voluminous sales to associated enterprise were too high, and concluded that 10% was reasonable as against the 40% claimed by the taxpayer. Further, the transfer pricing officer concluded that the adjustment of interest at 12% per annum was reasonable, as the interest rate during that year was around 12% as compared to the 18% per annum sought by the taxpayer. The transfer pricing officer allowed a 5% adjustment for the credit risk. However, for annual and future business adjustments, the transfer pricing officer rejected the claim of the taxpayer on the grounds that this was a repetition of the volume factor. The transfer pricing officer concluded that except for the volume factor, credit period adjustment and credit risk adjustment, the international transactions were comparable considering Rule 10B(2) of the ITR.

The transfer pricing officer arrived at the conclusion that the transactions were comparable on the grounds that (1) specific characteristics of the property transferred in both the cases were identical; (2) functions performed, taking into account assets employed and risks assumed by the respective parties to the transactions, were the same except the credit risk (discussed above); (3) the delivery terms were the same in both cases; although the payment terms differ, necessary adjustments were made; and (4) the conditions prevailing in the markets in which the respective parties to the transactions operate can be considered as similar because the related entity was located in Thailand and the unrelated party in Vietnam. Thus, both the parties were located in Southeast Asian countries and therefore the geographic areas of the countries appeared to be comparable. Further, the incidence of disease for which the medicine (injectible ampoule) was used was also most likely to be the same. In both of the countries the retail prices were also similar.

Based on the above, the transfer pricing officer made an upward addition to the export transactions with the taxpayer's associated enterprises. On appeal, the Commissioner (Appeals) partly allowed the appeal of the taxpayer by admitting further adjustments to the price on account of the volume discount and the credit period.

Aggrieved by the order of the Commissioner (Appeals), the taxpayer sought an appeal before the Tribunal.

2.7.2. *Ruling of the Tribunal*

The Tribunal observed that when there is a sale of an identical product to an unrelated party, the CUP method will be the basis for determining the arm's length price with regard to sales to an associated enterprise. However, one of the essential prerequisites is that reasonably accurate adjustments be able to be made to eliminate material factors affecting price, cost or the profit arising from such transactions. At a minimum, all material factors should be considered in arriving at the adjustments.

The Tribunal found that the transfer pricing officer and the Commissioner (Appeals) have assumed similarity of markets and economic conditions, and have made adjustments only for the volume discount, credit offered and a small adjustment for credit risk. They have completely ignored the disparate economic market conditions in Thailand and Vietnam, and made no adjustment for the same. Mere geographic contiguity of two countries need not lead to the conclusion that there is similarity in economic or market conditions. How can the sale prices to wholesale agents in two different countries be comparable, when the sale price to the final user in one country is lower than the sale price to the wholesale agent in another, unless adjustments for the same have been considered? Thus, the adjustments merely for volume off take, credit period and credit risk, although material, are not sufficient to make the sale price to associated enterprise in Thailand comparable with sales to an unrelated party in Vietnam.

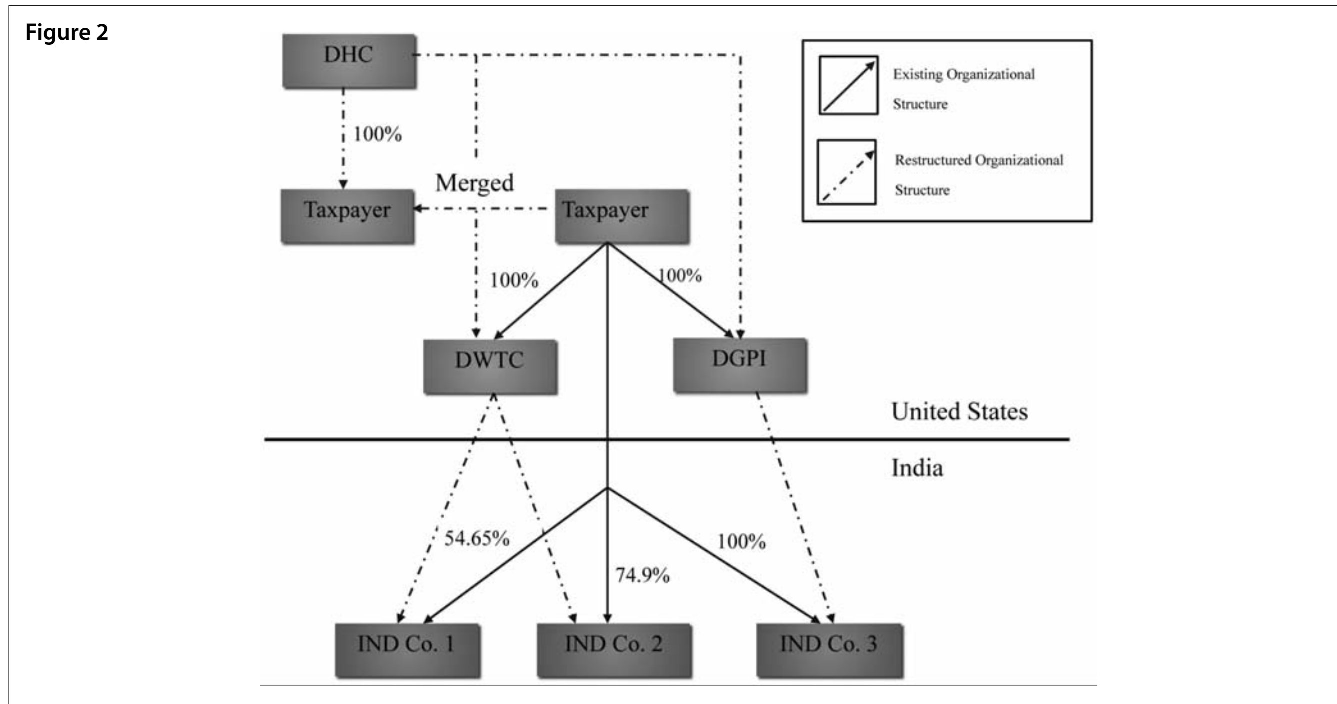
Thus, the Tribunal set aside the matter to the file of the Commissioner (Appeals) for deciding the matter afresh after giving reasonable opportunity to the taxpayer to present its case.

2.7.3. *Rationale of the ruling*

This judgement clearly underscores the importance of the most critical element of any transfer pricing analysis, namely the use of comparable data for the purpose of benchmarking controlled transactions. Further, the standard for comparable data when applying the CUP method is more stringent, and the need for similar economically relevant transactions is of paramount importance. The application of the CUP method for determining an arm's length price hinges upon one of its essential prerequisites, specifically that reasonably accurate adjustments be able to be made to eliminate material factors affecting price, cost or the profit arising from such transactions. Transfer pricing is not an exact science and thus there is no formal set of rules as to what constitutes "reasonably accurate adjustments". However, at the same time it may also imply that where reasonably accurate adjustments cannot be effected, the CUP method cannot be used as the most appropriate method to determine the arm's length price for benchmarking the international transaction between associated enterprises.

The ruling of the Tribunal has further emphasized that when analysing a transaction between associated enterprises vis-à-vis transactions with unrelated parties, a transaction must be evaluated in their totality for purposes of determining the arm's length nature of such transaction.

Figure 2



2.8. *In re. Dana Corporation*[9]

2.8.1. Facts of the case

Dana Corporation (the taxpayer), a company incorporated in United States, filed for bankruptcy. The taxpayer owned shares in two US entities, namely Dana World Trade Corporation (DWTC) and Dana Global Products, Inc. (DGPI). The taxpayer also had three subsidiaries in India. As part of the bankruptcy proceedings, a reorganization plan was submitted to the US Bankruptcy Court. A new holding company (DHC) and a limited liability company (DCLLC) were formed as part of the plan. Thereafter, the taxpayer transferred the equity shares held by it in two of the Indian companies to DWTC, and the shares of the other wholly owned Indian company were transferred to DGPI. The transfer was without consideration in terms of the share transfer agreements.

As a part of bankruptcy transfers, an independent private equity concern infused capital into DHC in exchange for shares of DHC; additional shares of DHC were distributed as settlement for certain claims made against the taxpayer; the taxpayer transferred shares held in DWTC and DGPI to DHC; and the taxpayer merged into DCLLC in accordance with the articles of merger. In effect, indirect control over the Indian companies was transferred to DHC. It was stated that the liabilities assumed by DHC from the taxpayer were more than the assets. The holding structure of this transaction can be illustrated as in Figure 2.

The main question raised by the taxpayer through its successor company DCLLC (the Applicant) before the Authority for Advance Rulings was whether the transfer by the taxpayer of shares of Indian companies is taxable under the Income Tax Act.

2.8.2. Decision of the Authority for Advance Rulings

2.8.2.1. Capital gains: transfer of shares

It is settled law that Sec. 45 of the ITA (the charging section for capital gains) must be read with Sec. 48 of the ITA (operating provision for computation of capital gains), and if the computation provision cannot be given effect for any reason, the charge under Sec. 45 fails. In this regard, reliance was placed on the decisions of the Supreme Court in *CIT v. B.C. Srinivasa Shetty*[10] and *Sunil Siddharthbhai v. CIT*.[11]

The Authority for Advance Rulings held that the profits or gains envisaged by Sec. 45 of the ITA are not something which remains uncertain, indefinite or indeterminable; if the profits or gains or the full value of the consideration cannot be arrived at, then it cannot be arrived at on a notional or hypothetical basis, either. The profits or gains to the transferor must be a distinctly and clearly identifiable component of the transaction.

As for the argument of the tax authorities that the liabilities assumed can be regarded as consideration, the Authority for Advance Rulings observed that one cannot find consideration for the transfer by means of conjecture and assumption. When the entire assets and liabilities of the taxpayer were assumed by DHC (which is neither transferor nor transferee) in order to reorganize the business, it is difficult to envisage that a portion of the liabilities constitutes consideration for the transfer, notwithstanding the fact that such consideration was never defined nor identified. The recital in the share transfer agreement that the transfer was effected without consideration therefore reflects the correct position.

9. 186 Taxman 187 (Authority for Advance Rulings).
10. 128 ITR 294.
11. 156 ITR 509.

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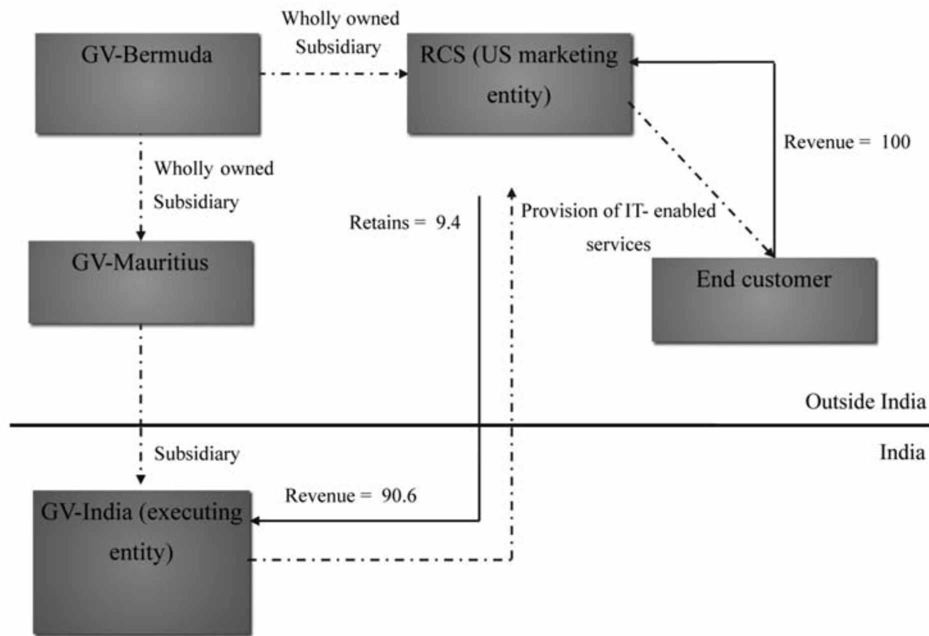
Figure 3



The Authority for Advance Rulings, therefore held that the facts on record, judged in light of the reorganization plan, lead to a reasonable inference that there was no consideration for the transfer, or at any rate the consideration is indeterminable and therefore the charging provision (Sec. 45) becomes inapplicable.

2.8.2.2. Application of transfer pricing regulations

If no consideration had passed from or on behalf of the transferee companies to the transferor company and the charge under Sec. 45 fails to operate for want of consideration or determinable consideration, obviously, the provisions in Sec. 92 of the ITA (the charging section for transfer pricing purposes) do not come to the aid of the tax authorities. It must be noted that Sec. 92 is not an independent charging provision. The opening part of this provision states that "any income arising from an international transaction shall be computed having regard to the arm's length price". The expression "income arising" postulates that the income has arisen under the substantive charging provisions of the ITA. In other words, the income referred to in Sec. 92 is nothing but the income captured by one or the other charging provisions of the Income Tax Act. In such a case, the computation aspect is taken care of by Sec. 92 and other related provisions in Chap. X (Transfer Pricing Regulations). Sec. 92 obviously is not intended to bring in a new head of income or to charge tax on income which is not otherwise chargeable under the ITA.

2.8.3. Rationale of the decision

Although the decision of the Authority for Advance Rulings is applicable only in the case of the applicant that has sought it, it nevertheless carries persuasive value. It reinforces the proposition that Sec. 92, dealing with the evaluation of income arising from an international transaction, how to determine whether it is at arm's length, comes into play only if such income is taxable under Secs. 4 and 5 of the ITA (charging sections). Thus, if there is no income or the income cannot be brought to charge under the Income Tax Act, Sec. 92 cannot come into play.

Hence, the authors believe that this ruling could assist taxpayers in cases where no or indeterminable consideration flows from a transfer of assets, as such transfer could escape the charge of tax and consequently, would also escape the mischief of Sec. 92.

2.9. *Global Vantedge (P.) Ltd. v. DCIT*[12]

2.9.1. Facts of the case

Global Vantedge Private Limited (the taxpayer) was a subsidiary of Global Vantedge, Mauritius (GV-Mauritius), which in turn was a wholly owned subsidiary of Global Vantedge, Bermuda (GV-Bermuda). The taxpayer was engaged in rendering information technology-enabled services in the field of credit collection and telemarketing services and is eligible for the deduction under Sec. 10A of the Income Tax Act as an STPI[13] unit. The RCS Centre Corp (RCS), a Delaware corporation, was a wholly owned subsidiary of GV-Bermuda. As GV-Bermuda is shareholder of both the taxpayer and RCS, holding more than 26% of the shares (directly and indirectly), they were deemed to be associated enterprises by virtue of Sec. 92A(2)(b) of the Income Tax Act. RCS was engaged in the business of contracting with clients located in the United States, to provide them with debt collection and telemarketing services. RCS did not own the requisite infrastructure or capacity for the execution

12. 37 SOT 1 (Delhi Tribunal).
13. Software Technology Parks of India.

of that work. The work was actually performed in India by the taxpayer under an arrangement with RCS. The taxpayer and RCS had entered into an agreement under which the taxpayer performed the work for clients that entered into contracts with RCS. Once a client was identified by RCS and a contract finalizing the terms of services was entered into, a corresponding work order was executed by RCS with the taxpayer to perform that work. During the year under consideration, the taxpayer received a sum from RCS for client services by the taxpayer (which was 90.6% of the revenue earned by RCS from clients). In addition to rendering services to the clients of RCS, the taxpayer also rendered services to other independent clients, the latter of which gave rise to approximately 18% of the total revenue earned by the taxpayer.

The operational model is depicted in Figure 3.

During the assessment proceedings, the transfer pricing officer after analysing the international transaction, business model and the relationship between the assessee and associated enterprise, concluded that the associated enterprise was not to be treated as a tested party. The transfer pricing officer chose the taxpayer itself as the tested party and identified nine Indian comparables. The average operating margin of the comparables was 11.88%, as against the loss of 53.5% incurred by the taxpayer. Applying the arm's length margin of 11.88% on the total operating cost, the transfer pricing officer proposed an adjustment.

The Commissioner (Appeals) partly ruled in favour of the taxpayer by concluding that the total adjustment together with the arm's length price cannot exceed the total revenue earned by the taxpayer and its associated enterprise from third-party independent clients.

2.9.2. Ruling of the Tribunal

The Tribunal heard the arguments of both the taxpayer and the tax department, and confirmed the findings of the Commissioner (Appeals) as follows:

Tested party. The Commissioner (Appeals) agreed that the least complex party (i.e. the simpler entity) should be considered as the tested party, as it requires fewer and more reliable adjustments to be made to its operating profit margins. However, in the instant case, the Commissioner (Appeals) rejected the contention of the taxpayer to consider the associated enterprise (a foreign company) as the tested party, as it is difficult to compare entitlements in different jurisdictions because the facts and circumstances vary in each geographic location. Further, it is difficult to obtain all relevant facts that could lead to a proper analysis of functions, assets and risks, and the relevant data which may be required to make the requisite adjustments are very difficult to obtain in relation to the foreign comparables.

Revenue-sharing arrangement. With regard to the revenue-sharing arrangement between the entities, what may be questioned is the proportion of sharing between the entities and not the absolute amount of revenue itself which is subject to sharing, as that is beyond the control of both the taxpayer and its associated enterprises. This is in view of the fact that the Indian transfer pricing regulations require an analysis of only the transactions between associated enterprises and not transactions with third parties, as extraneous factors cannot be controlled. Moreover, if an entity is unable to earn adequate profits on account of legitimate business exigencies and not due to the manipulation of transactions undertaken by the associated enterprises, such entity cannot be penalized. Therefore, applying the above logic and considering the revenue-sharing arrangement between the parties, the total adjustment made in the hands of the taxpayer together with the arm's length price already reported by it cannot exceed the total revenue earned by the taxpayer and its associated enterprise from third-party customers.

Compensation for marketing function. In determining the fees payable to any agency responsible for marketing, important factors that need to be considered are the complexity of the process being outsourced, the operating margins that the service provider is expected to earn and the size of the contract. Accordingly, based on the report on the Indian business process outsourcing industry prepared by INGRES,[14] the industry average (average expenditure on selling expenses in the software industry) for the financial year under consideration at 1.40% is very much reliable, and thus 1.40% of the revenue is adequate to compensate RCS for its marketing function.

Application of the TNMM. In cases where the TNMM is used as the most appropriate method to determine the arm's length price, as the name of the method itself suggests, it is the profitability of transactions rather than the profitability of an enterprise that is to be evaluated. Accordingly, when applying the TNMM to determine the arm's length price, the revenue earned by the taxpayer from servicing third parties, without any involvement of associated enterprises, should not be considered. Thus, an adjustment to the arm's length price is to be limited to international transactions.

Adjustments to comparables. If the comparable companies have substantial related-party transactions, these should be rejected. Further, the data on comparables to be used for determining an arm's length price must be contemporaneous. As the taxpayer was in the start-up phase of operations, the adjustments on account of surplus capacity and working capital should be made to the comparables.

2.9.3. Rationale of the ruling

The Ruling of the Tribunal emphasized that when analysing a transaction between associated enterprises, a transaction must be evaluated in their entirety in order to determine the arm's length nature of such a transaction. Therefore, in the case of Indian multinationals the

14. A division of ICRA Ltd.

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main economic substance of which rests in India, and the marketing entity of which is set up outside India to garner business, the methodology to compensate the associated enterprise for its marketing function must be determined after considering the total fees received from the third-party customer. Further, the ruling reiterates the philosophy that when applying the TNMM, in order to limit the evaluation, any adjustments are to be made only to the set of international transactions and not to the whole entity.

The ruling accepts the concept of the tested party being the more economically simple party, but seems to fall short of accepting the foreign associated enterprise as the tested party due to the limitation of foreign comparables. Hopefully, as India matures into a robust tax regime, this limitation will be overcome.

Further, the acceptance of an independent consultant's report (the INGRES report in this case) as a benchmark, which acts as an indirect CUP or in fact a comparable transaction, probably needs more in-depth analysis before it can become an accepted benchmark in transfer pricing evaluation. The methodology applied to use the INGRES report to evaluate the average expenditure on selling expenses in the software industry, has not captured the nuances of applying Indian company analysis to foreign jurisdictions, without considering the disparity of cost in India and foreign jurisdictions.

2.10. *CA Computer Associates Pvt. Ltd. v. DCIT*[15]

2.10.1. Facts of the case

CA Computer Associates Pvt. Ltd. (the taxpayer) was incorporated in 1998 and was a 100% subsidiary of Computer Associates International Inc. United States (CA US). The taxpayer was primarily engaged in the business of (1) licensing mainframe midrange and system infrastructure software products of CA Management Inc. US (CAMI US); (2) software that can be generally deployed "out of the box" or with customer/industry specified adaptations; and (3) development software that can allow technologies and programs to write custom applications and create new categories of packaged applications. The taxpayer had set up a technical support centre in Chennai to provide support services to end users of the software products on behalf of CAMI US. Under the agreement with CAMI US, the taxpayer was appointed as the sole distributor of CAMI US products in India.

In the year under consideration, the taxpayer declared a loss in its return of income. The taxpayer paid royalties amounting to approximately USD 1.65 million to CAMI US for distribution of the software products in India. The taxpayer had benchmarked this royalty payment using the CUP method. However, the transfer pricing officer determined the arm's length price at nil in relation to the royalties to the extent of USD 105,000 paid to CAMI US, which corresponded to sales of approximately USD 3 million written off as bad debts in the books of account, on the following grounds:

– The transfer pricing officer observed that the taxpayer had written off sales amounting to approximately USD 3 million as bad debts, and the invoices corresponding to such written-off sales were also made by the taxpayer during the same financial year under consideration. Further, the write-off decision was also taken in all the cases by the meeting of the board of directors of the company during the same financial year.
– Once the decision to write off of bad debts for the invoices made during the previous year was taken in the same financial year, this amount would be reflected as an amount not receivable in the monthly reports, which would be available with the licensor. If such reports were available with the licensor with regard to the amount of invoices made during the year and written off during the year, the licensor should not have claimed royalties on such amounts written off, in the debit note made on the last day of the financial year under consideration.
– Any independent entity, acting as the sole distributor of the off-the-shelf products of a licensor, would have sought a waiver of royalties payable, considering the huge amount of non-receivables which ultimately it is forced to write off as bad debts.
– The taxpayer should have asked for a waiver of royalties corresponding to such write-off. Indeed, any independent entity that is merely a distributor of products could have asked for such a waiver, irrespective of the terms of the relevant agreement. When the taxpayer could not realize the amounts from the clients for the products distributed that belonged to CAMI US, how could a royalty be regarded as payable? Independent entities acting independently of each other would certainly enter into an agreement for payment of royalties on the basis of actual collections made and not on the basis of mere invoicing.
– The contention of the taxpayer that it paid royalties at a lesser rate than paid in comparable uncontrolled transactions, is not relevant in the present case because regarding the royalty rate there is no dispute that it is arm's length. Rather, the case at hand deals with the specific issue of royalties on invoiced amounts written off during the year itself.
– The taxpayer was only acting as a distributor of products that belonged to the licensor; these were the initial years of the taxpayer's business in the country; and bad debt risks were likely to be present. These facts would certainly be considered by independent parties when entering into a distributor agreement, and non-payment of royalties on the non-realization of the proceeds would certainly be a condition in an agreement entered into on an arm's length basis.

15. 2010-TIOL-68-ITAT-Mum (Mumbai Tribunal).

The Commissioner (Appeals) upheld the order issued by the transfer pricing officer. The taxpayer subsequently filed an appeal before the Tribunal. The core issue before the Tribunal was not the method which had been adopted for determining the arm's length price, but rather the way it was determined by the transfer pricing officer.

2.10.2. *Ruling of the Tribunal*

The Tribunal observed that the manner in which the arm's length price is to be determined by any of the methods is prescribed in Sec. 92C of the ITA read with Rule 10B of the Rules. After examining the parameters under Rule 10B, it is apparent that bad debts written off cannot be a factor in determining the arm's length price of any international transaction. The transfer pricing officer exceeded his limitation by following a method that is not authorized under the Act or the Rules. Therefore, the arm's length price determined by the transfer pricing officer and adopted by the assessing officer with regard to royalties payable to CAMI US is not in accordance with the procedure prescribed and cannot be sustained. The assessing officer was directed to adopt the arm's length price of the royalties payable to CAMI US as declared by the taxpayer.

2.10.3. *Rationale of the ruling*

Under the transfer pricing regulations, any income or allowance for any expense arising from an international transaction must be computed having regard to the arm's length price. The arm's length price cannot be determined merely on the basis of the methods prescribed under Sec. 92C(1) read with Rule 10B. The application of the methods hinges on the functional and economic analyses, which are the cornerstones of transfer pricing. Transfer pricing is not an exact science. Therefore, it may not be necessary that methods prescribed under the transfer pricing regulations be the only means for determining the arm's length nature of a controlled transaction. The dynamic nature of business may not always allow the application of the specified methods for benchmarking unique transactions. The authors believe that the arm's length standard, which is the foundation of transfer pricing law in India and around the world, is flexible enough to absorb the vicissitudes of business and is not straitjacketed by only the methods specified by law. Thus, this decision should be read with the facts of the case and may not have universal application for all unique transactions.

The authors believe that royalties are normally paid to a licensor for the exploitation of intangibles, and therefore the exploitation of intangibles and the realization of sales by the licensee are two independent transactions, although the compensation methodology for royalties is normally based on the turnover of the licensee. Otherwise, the basic intention of entering into a licensing arrangement would be defeated, as the licensor would always share in the profit or loss of the licensee, according to the position of the tax authorities.

3. Way Forward

The transfer pricing audit outcomes and the evolution of the Indian jurisprudence on the subject clearly show that the multinationals will have to consider Indian transfer pricing issues as high on their management agenda. As a consequence of the current global crisis even developed economies are now extremely zealous in protecting their tax base, and the approach of the Indian tax authorities should be seen in the same light. The continuing Vodafone saga regarding the right of the Indian tax authorities to tax gains on the transfer of shares outside India between two non-residents, although the shares derived value from the operating assets of the Indian subsidiary, and the recent upholding of the position of the Indian tax authorities by the Bombay High Court, clearly indicate that multinationals will need to strength their defence mechanisms as regards various transfer pricing issues in India.

Thus, the correct economic analysis which brings out the true economic substance of the controlled transaction, the depiction of risks undertaken and other relevant documentation will help taxpayers to discharge their burden of proof under the Indian transfer pricing regulations and demonstrate adherence to the arm's length standard. The importance given by the appellate authorities to the function, assets and risk analysis; the analysis of comparables; and the selection and application of most appropriate method, are the pointers for taxpayers. It is again reiterated that a mechanical approach to transfer pricing, with an emphasis on mere quantification, will not be sufficient to protect taxpayers and discharge their burden of proof as required under Indian transfer pricing regulations.

These are early days for both the taxpayers and the tax authorities as transfer pricing is slowly evolving in India from its nascent stage. The other finer issues and nuances of transfer pricing, especially in the field of transfers of intangibles, the question of location savings when performing high value-added services, the economic adjustments for varying business models, etc. will come to light, as these issues are hotly debated before various appellate forums.

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